Good Governance of the National Petroleum Sector

The Chatham House Document

Glada Lahn, Valérie Marcel, John Mitchell, Keith Myers, Paul Stevens

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The Royal Institute of International Affairs
Chatham House
10 St James's Square
London, SW1Y 4LE
T: +44 (0) 20 7957 5700
F: +44 (0) 20 7957 5710
www.chathamhouse.org.uk

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Good Governance of the National Petroleum Sector

This document introduces the results of a two-year project, led by Dr Valérie Marcel with Professor Paul Stevens, to find out what constitutes good governance of the petroleum sector from a national perspective. It condenses the project's findings and recommendations into **5 principles and 40 benchmarks**. These are uniquely based on a dialogue in which decision-makers from 23 oil- and gas-producing countries shared their experience and worked towards a set of common goals and guidelines.[1] Together, the benchmarks form a broad framework for good governance of the sector and a springboard for making practical improvements to governance systems.

The Good Governance of the National Petroleum Sector project

In many developing countries, petroleum[2] is the primary source of government revenue. Failures of petroleum sector governance can have far-reaching implications for the economy, social development and political stability. By the same token, a well-governed sector will increase national wealth, sustainable development and social stability. This project took as its starting point the fact that these benefits are more likely to be achieved if all stakeholders share an understanding of what good governance requires in practice. Beginning in February 2005, Chatham House, London and the Centre for Energy, Petroleum and Mineral Law Policy (CEPMLP) at Dundee University facilitated a series of workshops involving participants from government, national and international oil companies, NGOs and financial institutions from oil- and gas-producing countries at different stages of development. The conclusions have been supplemented with in-house research on international governance practices to produce this document and the more detailed *Report on Good Governance of the National Petroleum Sector*. The latter provides examples from country case studies and offers checklists and guidance for the petroleum sector policy- or strategy-maker.[3]

This project is separate from other governance initiatives such as the Extractive Industries Transparency Initiative (EITI), which focuses on resource revenues, and the International Monetary Fund's *Code of Good Practices on Fiscal Transparency*, which focuses on fiscal processes in the government sector. Although there are some natural complementarities, our project addresses petroleum sector governance at a broader level. Recommendations are based primarily on producers' experience and aspirations, including those of countries actively engaged in the EITI or IMF programmes. We hope that the project's findings will form a foundation for 'good governance' dialogues among national petroleum sector stakeholders around the world and promote a greater awareness of the rich breadth of experience upon which producing countries can draw.

What is in this document?

This document is divided into five parts:

1 What is petroleum sector governance?
2 The importance of the national context
3 Participants in governance and four essential governance functions
4 Five universal principles of good governance
5 Improving governance: 40 benchmarks

1 Participants involved in the project came from: Algeria, Angola, Azerbaijan, Brazil, Colombia, Egypt, India, Iran, Iraq, Kazakhstan, Kuwait, Libya, Malaysia, Mexico, Nigeria, Norway, Saudi Arabia, Suriname, Trinidad & Tobago, the United Arab Emirates, the United Kingdom, the United States of America and Venezuela.

2 The word 'petroleum' refers here to both oil and gas.

3 The first edition of the *Chatham House Report on Good Governance of the National Petroleum Sector* is a 'living document' that can be revised on the basis of comments and suggestions from petroleum sector representatives around the world. It is available at www.chathamhouse.org.uk/goodgovernance

1. What is petroleum sector governance?

Petroleum sector governance refers to the system for making and implementing decisions concerning the exploitation of a nation's oil and gas resources. It includes the structural and hierarchical **organization** of the sector, its decision-making and communication **processes**, the **policies and objectives** governing its activities and the **regulation** of those activities. There is a wide range of producer experience and many sectors are undergoing reforms in these four areas.

2. The importance of the national context

It was clear from the outset that there could not be a detailed, one-size-fits-all model for good governance of the petroleum sector. Each country has a unique context and set of customs and values which influence how political power and legal authority are distributed and exercised. Defining factors include: the type of political system; the level of dependence on petroleum; the life-span of resources; the level of national economic and educational development; the organization and capacity of government ministries and agencies; international obligations (such as membership of OPEC, the World Trade Organization, the UN Framework Convention on Climate Change or the UN Global Compact); the legal framework for the petroleum sector; and the nature of civil society. The national context evolves over time and petroleum sector governance has to adapt in response.

Given these conditions, the project has:

- sought universal principles and generally applicable guidelines to which all producers can subscribe
- described how governance can be improved within certain national contexts
- drawn up a set of benchmarks against which producers can assess themselves and identify potential improvements

The project has focused on countries that have a national oil company (NOC), although many of the principles and benchmarks apply equally to countries without one. Many NOCs now have shares or bonds listed on securities and stock markets and so fall under codes of private-sector corporate governance and reporting. We do not replicate or draw from these codes here although there may be some obvious linkages.

3. Participants in governance and essential governance functions

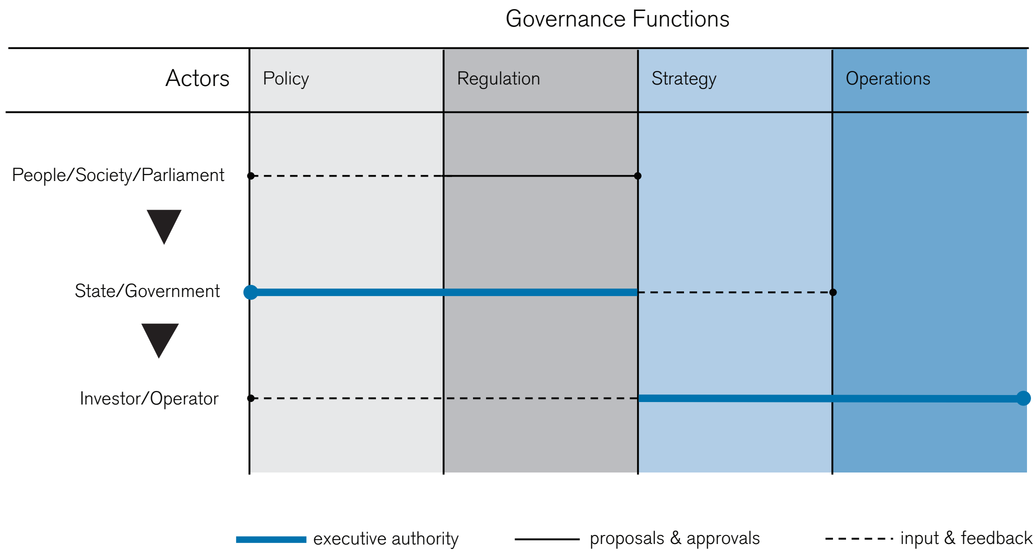
Executive actors and stakeholders in a country's petroleum governance can be divided into three groups: **State/Government**, **People/Society** and **Investors/Operators**. State/government actors may include the executive, ministries, the national bank, a petroleum advisory council, official regulators, local authorities and legal institutions. People and society may be represented by parliament, trade unions, the media, civil society groupings etc. The investor/operator grouping includes the national oil company, local private-sector companies, international oil companies and financial institutions. The relations between these groups vary from country to country; for example, the NOC is sometimes more of a government agency than an operating company.

Participants have agreed that four governance functions are essential:

1. **Policy-making** – setting direction, goals and objectives
2. **Strategy-making** – translating policies into plans of action
3. **Operational decision-making** – implementation of policy
4. **Monitoring and regulation** – providing assurance and compliance

Figure 1 shows a desirable generic model for the distribution of functions between the different stakeholders/actors. People delegate responsibility for policy-making to government which, in turn, delegates responsibility to operating companies to carry out oil and gas operations. People/society hold government accountable for the policies. State/government holds the operators accountable for implementation of those policies. Several actors may be involved in the same function but each has a specific role within the decision-making process. The investors/operators provide the information and feedback to enable appropriate regulatory standards and policies. People/society contribute to policy-making debates, are ultimately responsible for the approval of the chosen policy, and can assist in the monitoring and regulation of operations in the sector through media investigation, industry analysis and direct communication with the sector.

Figure 1: A generic demarcation of functions between principal actors in the oil and gas sector



4. Five universal principles of good governance

Most importantly, the project established five universal principles which underpin good governance in the petroleum sector. They are listed in Table 1, together with the related questions that all systems of governance must address.

The **national context** will influence the extent to which these principles are currently implemented and may pose specific challenges for countries attempting to improve their governance systems. The *Report* suggests more context-specific responses to each of the above questions.

5. Improving governance: 40 benchmarks

A set of 40 conceptual benchmarks for good governance, which can help assess governance systems and identify strengths and weaknesses, is given in this section. Issues are naturally interrelated and are cross-referenced where possible.

Table 1: The five principles of good governance

	Governance principle	Related questions
1	Clarity of goals, roles and responsibilities	• Who sets objectives, targets and regulations for the sector? • How are functions distributed and roles defined? • How is authority delegated and how are responsibilities defined?
2	Sustainable development for the benefit of future generations	• What objectives are chosen for the sector and why? • How do objectives and regulations contribute to sustainable development?
3	Enablement to carry out the role assigned	• What does each actor need to perform his or her role effectively? • What can each actor do to help enable other actors?
4	Accountability of decision-making and performance	• How can decision-makers be held to account for compliance and performance?
5	Transparency and accuracy of information	• What information do those involved in the decision-making process need to make good decisions? • How does the government/shareholder know objectives are being met?

1. Clarity of goals, roles and responsibilities

Whatever the organizational model for governing the petroleum sector, *clarity of goals, roles and responsibilities between agencies* is crucial. Because of its special importance to national politics and economics in many countries, the petroleum industry can be prone to overlaps in political and commercial decision-making. Lack of clarity can lead to conflicting agendas, duplication of effort and policy paralysis. Defining who should be responsible for what and what each actor's objectives are requires a high degree of *transparency* and *enablement,* as described under sections 3 and 5.

1.1 National development objectives and the role of the oil and gas sector in contributing to those objectives are clear and well communicated.

1.2 The roles of (a) policy-making, (b) strategy-making, (c) operational decision-making and (d) monitoring and regulating industry activity are clearly defined and assigned to individuals and/or agencies (see also 3.3 and 5.1).

1.3 Responsibility for the regulatory functions is assigned to allow for objective, fair and independent oversight, to avoid conflicts of interest and to minimize duplication of effort (see also 3.6).

1.4 Where there is an NOC, its purpose and mission are well defined and its objectives are transparent and aligned with national development goals (see section 2).

1.5 The NOC's operating role is defined in a way that allows commercial and non-commercial responsibilities to be distinguished, and prioritized if necessary.

1.6 The legal framework for the NOC clearly defines the rights and responsibilities of shareholders and other stakeholders.

1.7 The governance structure specifies the role of the NOC board, the limits of its authority, what it is accountable for, and to whom (see 4.1).

1.8 The legal, fiscal and regulatory framework in which foreign and private operators/service companies will operate and any obligations to the country beyond their agreed work programme are clearly defined in their contracts.

2. Sustainable development

As a capital-intensive, rather than people-intensive industry, dependent on finite resources, sustainability must be at the heart of petroleum sector policy-making. Sustainable development policies aim to meet the needs of the present without compromising the well-being of future generations. This will involve questions of the sector's long-term social and environmental impacts and how it can best contribute to general national development and the non-petroleum sectors (though the use of state petroleum revenues once in the hands of the government treasury is not treated here). The petroleum sector (NOC and private sector, if any) may be subject to policies and objectives aligned with national development goals. Most importantly, these objectives should be assigned to the actor best placed to perform the role efficiently and accountably. A period in which the relevant capacity and authority are transferred from one agency to another may be necessary (see also section 3).

2.1 The national petroleum revenue management system provides for fiscal stability, and gives assurance that petroleum resources contribute to sustainable benefits for future generations (see also 3.4).

2.2 Education and training are sufficient to meet the sector's needs and the transfer of skills to the non-oil sectors is promoted.

2.3 Fair and realistic local procurement and employment policies promote human capacity technology transfer and diversification of the economy.

2.4 Corporate social responsibility (CSR) policies and programmes are aligned with a national development agenda (see 3.11 and 4.7)

2.5 The 'opportunity cost' of giving social objectives to the sector is thoroughly assessed (see 3.5).

2.6 The promotion of social welfare and/or economic development through selling petroleum products at below international prices to national consumers are pursued only as part of a fair, transparent and costed policy, for example, to smooth the effects of fluctuations in international prices or address questions of energy poverty.

2.7 Effective processes are in place to ensure that the development of hydrocarbon infrastructure and its operations do not result in long-term damage to local and regional environmental assets (see 4.1 and 4.5).

3. Enablement to carry out the role assigned

Enablement is a major issue for producers because there is often a mismatch between where skilled people are concentrated (in the operating companies) and where they are also needed (in the ministry, regulator or broader government). Likewise, the remit of authority and financial capacity of an actor may not be sufficient to meet the objectives and responsibilities assigned to it. For optimum performance, each actor must have access to the necessary means in terms of authority, financial resources, information, human capacity (skills, knowledge, experience etc.) and supporting processes.

3.1 Policy-makers have sufficient knowledge, capacity and internal alignment to set effective policy and realistic and prioritized objectives for the sector (see 5.2).

3.2 Checks and balances are in place at government level to enable consistency for long-term policy-making.

3.3 Actors are delegated financial and managerial authority to carry out their role and/or function (see also 1.2).

3.4 The fiscal and budgetary relationship of the NOC to the state is structured to enable the NOC to achieve its objectives efficiently, i.e. there are checks and balances to ensure that NOC spending is in the national interest; the NOC is able to make purchases and investments promptly and has the stability to make long-term investment plans.

3.5 There is an exit strategy to enable the NOC to transfer any non-commercial, social and/or national development functions to the government or other agencies when they are ready and able to take over.

3.6 The selection criteria for appointments to the NOC board and executive management are transparent and the board has the appropriate knowledge, skills and resources to carry out its role (see 5.7).

3.7 Operational and commercial decisions of the executive management and the Board are separated from political and other conflicting interventions.

3.8 The industry regulating bodies have the necessary technical skills, financial resources, knowledge, access and legal authority to exercise their powers effectively (see 1.4).

3.9 Audits of operators within the sector are coordinated to minimize duplication and avoid unnecessary bureaucracy (see 4.2).

3.10 Staffing decisions are based on the principle of 'best person for the job' (see 5.7).

3.11 NOC managers and employees are incentivized to improve performance (see 4.5).

4. Accountability for decision-making and performance

Accountability of decision-making and performance provides assurance to society that decision-makers (individuals and institutions) are identified and that their performance is assessed objectively. Accountability requires clear delegation, capable institutions and mechanisms of enforcement. Without it, corruption and malpractice can flourish and good practice can go unrecognized. In the national petroleum sector, the choice and empowerment of regulators and the role of society are key, although these may take different forms depending on the national context.

4.1 Mechanisms are in place to ensure that operators in the sector are in compliance with national and international regulations and contractual obligations (see 3.8).

4.2 The national petroleum sector as a whole is subject to regular audit, accounting for revenues due to the government, revenues paid to the government and revenues received by the government.

4.3 The NOC has internal audit functions (conducting financial, physical and process audits) which report to the board (see 3.9).

4.4 The NOC is subject to regular, functionally independent audited reports and accounts prepared to international accounting standards, such as the IFRS (International Financial Reporting Standards) (see 5.2 and 5.3).

4.5 NOC performance is benchmarked in a way that demonstrates relative as well as absolute performance i.e. functional performance against comparable organizations.

4.6 There is an effective mechanism for dialogue between local communities and operators to account for the impact of operational activities.

4.7 Corporate social responsibility/national mission spending in the petroleum sector is accounted for separately and evaluated against stated objectives (see 2.4).

5. Transparency and accuracy of information

Whatever the precise mechanisms of governance and accountability in a particular national context, their effectiveness depends on reliable and timely information. Those charged with defining roles and objectives for the sector must be aware of the capabilities and interests of each responsible authority; in turn, actors must be aware of the authority they are permitted and their limitations. Making information easily accessible and comprehensible is also an important step in increasing trust between society and the sector. Lower levels of trust are likely to require greater transparency. In cases of both listed and non-listed NOCs, the special relationship between NOC and government shareholder may require specific transparency measures.

5.1 A simple, comprehensive guide to the petroleum sector governance structure is available publicly (see 1.2).

5.2 The government and other shareholders receive timely and accurate financial and operational information from operators (see 3.1).

5.3 Where information about the sector remains confidential (not available publicly), the rationale for that confidentiality is explained and justified, for example by the need to preserve commercially sensitive information.

5.4 The cost of any non-market pricing of supplies of products to national consumers (including government and national companies) is identified, taking account of the appropriate market reference (see 3.1 & 3.4).

5.5 Criteria for awarding licences are published and licensing decisions are explained.

5.6 Criteria for awarding major government procurement contracts for the sector (including those awarded by the NOC) are published and major award decisions explained.

5.7 Employment policy for each agency within the sector is transparent.

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Chatham House
10 St James's Square
London SW1Y 4LE
T: +44 (0) 20 7957 5700
F: + 44 (0) 20 7957 5710
E: contact@chathamhouse.org.uk
Charity Registration Number: 208223

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CEPMLP
University of Dundee
Dundee DD1 4HN
Scotland, UK
T: +44 (0)1382 384300
F: +44 (0)1382 322578
E: cepmlp@Dundee.ac.uk